HORSES FOR COURSES

ARC's Florian Gröschl likens manager selection to choosing the right thoroughbreds for a race. Here, his five-step guide to building an absolute return fund of funds outlines the mind-set and discipline necessary to assemble a stable of winners

1. DEFINING MOMENTS

Before even beginning to construct an absolute return fund of funds it is key to define what the term means to you. For us it means generating positive returns every calendar year within a given risk budget. What we strictly try to avoid is having structural beta. This is essentially the same for the managers we select. Profiting opportunistically from market direction can either be viewed as taking beta risk or generating alpha from timing. Distinguishing between one and the other might be difficult at times and therefore, selecting absolute return managers is a very different exercise from what most market participants are used to. Given that absolute return is an asset call rather than a return target, the main difference to traditional asset classes is the asymmetry of risk/return profiles. The return stream should be manager driven instead of market driven.

2. MEASURING RISK – FORGET WHAT YOU KNOW

There are dozens of formulas and ratios that measure risk and what nearly all of them have in common is that they are built for symmetrical portfolios that are market dependent. This means that historical data, correlations and covariance are used to calculate portfolio risk. However, that only makes sense if market conditions change slowly – which they do not – and dependencies between markets stay more or less the same – which can also be proven otherwise. Therefore, the use of traditional risk measures like VaR in long-only portfolios is doubtful at best, but is completely useless in absolute return ones.

The ideal absolute return fund has an asymmetrical return profile, which might resemble the payoff of a call option or even better, making money in all market conditions. What it lacks, in any case, is the possibility of anticipating what the particular manager is doing next. Critics will say that if you know your manager and his portfolio you should be able to gauge how the fund will behave. Experience tells us that even the most educated guess on how the investor might react to changing market environments is often wrong. However, what we can measure is the realised volatility of a fund's NAV. Again, in most markets volatility changes over time, but capable mangers that define a volatility corridor they aim to move around in, will normally only leave that channel if they get it very wrong. That might then be the right time to sell.

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3. SELECTING THE FUND FOR YOUR NEEDS

The saying 'garbage in, garbage out' has particular relevance to fund selection in the absolute return space. While differences in benchmark-driven mandates normally result in incremental differences in performance, choosing the wrong absolute return manager will lead to a loss of capital. So apart from the normal due diligence every fund selector has to conduct, there are further stipulations for selectors in the absolute return space.

The following steps and criteria are crucial to the selection process:

1. **Manager meetings:** We only invest in funds where we have talked to the portfolio manager personally. Running absolute return strategies requires a different mind-set from long-only practitioners and this can only be confirmed through face-to-face contact.
2. **Meeting expectations:** It is vital that managers react to different situations in a way that is consistent with what they have said in advance.
3. **Killer question:** In every meeting we ask: 'What happens if you get it wrong?' There is only one answer that excludes managers from further investigation: 'We don't get it wrong.'
4. **Persistent track record:** We need to see that a manager is doing what he has done successfully before – ideally in different market environments.

4. PORTFOLIO BUILDING – AVOID CONCENTRATION

Having chosen all your horses for the race, it is crucial to assign each one to the place within the stable where it can best exercise its talent to add most to the overall success. This is basically done in two layers. The first is the overall asset/risk allocation and the second is the weighting each individual manager gets.

To facilitate this process we combine all the managers that extract their alpha from the equity space to one bucket, those who do the same in the fixed income market to another, and all those who do neither or both into a third bucket. By doing this we are normally able to avoid major setbacks if one group of managers undershoots for some reason. The latest example was the great sector rotation in late spring 2014, which caught most equity long/short managers on the wrong foot but left credit long/short counterparts unaffected. So again, market risk is not the variable to look at, but manager skill.

5. MANAGING RISK – KEEP IT SIMPLE AND DISCIPLINED

Every fund we select has by definition or by past return streams, a given volatility. We add this volatility to a manager's performance trend – if he drops out of his past volatility boundaries we half the position, if he drops out of the doubled volatility limit we sell out completely. We also apply technical predefined trend limits which might also lead to a reduction of the position even before volatility limits are reached.

In conclusion, selecting a manager rather than a market is very much dependent on finding talent or outstanding ideas. Constructing a portfolio and managing risk is solely about being disciplined and not overestimating one's own talent. ●

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WORKSPACE

Fund selectors reveal the tools and good luck charms they use to navigate the markets

FLORIAN GRÖSCHL
ABSOLUTE RETURN CONSULTING
AUSTRIA

CRYSTAL BALL
This reminds me that our work involves an element of uncertainty and therefore emphasises the importance of sticking to downside controls.

OUR RISK MANAGEMENT SCREEN
As long as the red area does not exceed the blue, we are happy.

TEA MUG
Tea keeps me focused, without making me twitchy.